Before the
Federal Communications Commission
Washington, D.C. 20554

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In the Matter of	)	
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Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services	)))	CC Docket No. 96-112

REPLY COMMENTS
OF THE
RURAL TELEPHONE COALITION

June 12, 1996

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SUMMARY

The Rural Telephone Coalition ("RTC") responds to the comments and proposals regarding allocation of costs between regulated and nonregulated activities of incumbent local exchange carriers ("LECs"), particularly with respect to costs associated with video programming services.

The commenting parties describe the effects that regulatory intervention in the form of a rigid cost allocation result would impart to the developing video marketplace. First, the rules should not hinder the development of a more open entry by LECs in video programming services. The comments also argue correctly that the Commission should not return to the overregulatory approach that developed in the previous video dialtone proceeding.

More importantly, rural LECs are also interested in deploying integrated systems for the delivery of video services to areas with no current or only rudimentary video services. LECs must not be faced with disincentives to invest in new technologies and service offerings. Cost allocation rules should not impede new technology or continue to promote inefficient service offerings to the detriment of users. Moreover, eligible telecommunications carriers should be encouraged in their efforts to promote universal service goals.

A fixed allocator or allocation caps would not serve the relevant goals and should not be adopted. The proposals in the *NPRM* would allocate an arbitrary and excessive amount of costs to video services. Several large carriers describe a modified allocator using a relative count of telecommunications and video users served. This approach -- while still not as consistent with the goals and intents of the 1996 Act as a flexible approach -- would reflect actual usage, would

permit a more gradual allocation to video as the mix of users change, and could still encourage productive use of existing telephone plant.

The delicate balance to be struck in fostering integrated delivery systems and advanced services argues in favor of more, rather than less, flexibility in the allocation rules. The current Part 64 rules are adequate to protect users and promote services.

For these reasons, the RTC recommends that the Commission limit any changes to Part 64 to granting the greater flexibility needed to promote video services. The Commission should reject any rigid allocation proposals. The Commission should promote vigorous investment in integrated video delivery systems without requiring new, nonregulated activities to bear an unreasonable share of costs. The goals established by Congress will best be served by this flexible approach.

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REPLY COMMENTS
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The Rural Telephone Coalition ("RTC") submits these Reply Comments in response to the comments filed on May 31, 1996, in the proceeding captioned above.[1] The comments were filed in response to the *Notice of Proposed Rulemaking*, FCC No. 96-214, released by the Commission on May 10, 1996, in this proceeding ("*NPRM*"). This proceeding is examining the manner in which incumbent local exchange carriers ("LECs") allocate their costs between regulated and nonregulated activities, particularly with respect to nonregulated provision of video programming services.[2]

The RTC is comprised the National Telephone Cooperative Association ("NTCA"), the National Rural Telecom Association ("NRTA") and the Organization for the Promotion and Advancement of Small Telecommunications Companies ("OPASTCO"). The three associations represent more than 850 small and primarily rural LECs in 46 states.

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[1] Unless otherwise indicated, all citations herein are to comments filed on May 31, 1996, in this proceeding.

[2] *NPRM* at para. 2.

I. PRESCRIPTION OF AN ALLOCATION METHOD WOULD HAVE A PROFOUND EFFECT ON THE PROVISION AND EVOLUTION OF ALL SERVICES.

Congress intends its recently enacted legislation, and the Commission's regulations, to ensure that consumers will receive high quality services and a full range of service offerings from a modern and evolving telecommunications network. These goals are to be achieved as the industry moves into the new era of telecommunications and information competition. The provision of broadband services, including video programming, will help meet the service interests and information needs of consumers, with special potential benefits to rural customers. Provision of video services in rural areas can increase network efficiency by augmenting economies of scale and scope to a degree even greater than in more densely populated areas with potentially multiple providers. The Commission should be equally concerned with promoting the delivery of advanced services and the achievement of greater economies by providers as it apparently is with potential cross-subsidy claims.[3] Rules lacking the necessary insightful balance within local markets between relative cost recovery and the benefits of video services would hinder the development of integrated telecommunications and video systems rather than fostering such advances.[4] The commenting parties reflect these same concerns.

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[3] It is predominantly sparsely populated areas that remain unserved and underserved with respect to video information and entertainment services.

[4] As the RTC partners have observed in other proceedings, the Commission may be attempting needlessly in rural areas to protect the users of regulated services from "cross-subsidizing" themselves. If flexibility in regulation means that LECs can viably offer both regulated telecommunications and video services that may otherwise not be available, whom are we trying to protect? Small and rural, locally-owned telephone companies already strive to achieve the most economically beneficial result for local areas in their choice of investment, service offerings and pricing.

Commenting parties point to the goals that Congress embraced with the passage of the Telecommunications Act of 1996. First, Congress repealed the former cross-ownership telco-cable restrictions 1) to allow more open entry into video services by LECs, 2) to promote competition with cable television companies, and 3) to terminate the former video dialtone ("VDT") overregulation that had developed under CC Docket No. 87-266.[5] LECs are poised to offer competitive video programming services in many areas in competition with cable companies. The Commission should not reverse the Congressional mandate by rejecting a "level playing field for incumbent carriers and competitors" in favor of a "continued emphasis on detailed cost allocation for the LECs" to "reincarnate[] . . . the regulatory burdens imposed by its VDT rules. . . ."[6]

Many rural LECs are also concerned with the deployment of integrated systems for the initial delivery of video programming services to areas with no video services or for superior systems in areas with only rudimentary levels of service. Bell Atlantic correctly observes that "an overallocation of costs can undermine the incentive to build modern broadband facilities . . . ."[7] US West claims that "this proceeding will impact significantly the incentives of incumbent [LECs] to deploy technologies that will bring competition to the video services marketplace, as well as

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[5] *E.g.*,USTA at 8; and US West at 3 ("In allowing common carriers to enter the video programming marketplace, Congress intended 'to promote competition, to encourage investment in new technologies and to maximize consumer choice of services that best meet their information and entertainment needs'" US West citing Conference Report at 172).

[6] USTA at 9. "If the Commission errs too far on the side of protecting the regulated ratepayer, there likely will be nothing to cross-subsidize." US West at 3.

[7] Bell Atlantic at n.26

their incentives to upgrade their networks . . ."[8] which the RTC extends to the incentives for LECs to invest even where competition may only arise in the future. BellSouth concludes that the Commission should be fully aware of the substantial effect on "incumbent LECs' incentives to risk capital in the deployment of advanced telecommunications infrastructure . . ." and should avoid miscalculations, otherwise "the Information Age Network could be postponed indefinitely."[9] BellSouth provides excellent direction in offering <u>four questions</u> which it suggests the *NPRM* does not adequately emphasize:

1. Should this proceeding promote investment in advanced telecommunications infrastructure?

2. Should this proceeding encourage incumbent LECs to be among the companies that invest in telecommunications infrastructure?

3. Should this proceeding promote competitive market conditions and enhance competition among providers of telecommunications, information, and video programming services?

4. Should this proceeding encourage incumbent LECs to be among the companies that provide competitive new telecommunications, information, and video services?[10]

The Commission's answers should be an emphatic <u>yes</u> to each.

The ability of rural LECs to deliver broadband infrastructure that would realize the economies of scale and scope available from an integrated, multipurpose network should not be lost in a cost allocation proceeding. The *NPRM* already recognizes that regulation should not

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[8] US West at 2. "If the Commission attempts to impose a rigid cost allocation regime that fails to account for the legitimate differences among the LECs, the Commission likely will send uneconomic signals to market participants that ultimately could retard the development of true, facilities-based competition in both the local exchange and video programming markets." *Id.*

[9] BellSouth at 4.

[10] BellSouth at 3-4.

impede, steer, or discriminate against what may be more efficient technology.[11] If the Commission persists in what the majority of commenting parties contend would be an overallocation of common costs to video services, arguably in excess of what a competitive market provider would choose to allocate, the results could be that the less efficient technology provider will persist, will be allowed to price just below the regulatory prescribed cost and price of the regulated potential competitor, and will be allowed to extract inefficient profits from consumers. With the wrong result, consumers would be denied more advanced, innovative and efficient technology and services offered at a lower price. Such a result creates "uncertainty and increases the incentive for incumbent [LECs] to construct separate facilities for the provision of unregulated activities."[12] Southwestern Bell warns that with overallocation of costs to video:

> . . . LECs would be at a competitive disadvantage and video consumers would be denied lower prices. More than any other mandatory allocator, the chosen factor would provide an incentive for lack of diversity, quality and robustness. Forced to allocate the same exact proportion of costs, the LEC's video business plans would be driven toward that "budget." Perhaps only a single architecture would fit that "budget." And, the losers would be the consumers whose competitive choices would be limited. . . . LECs would be at a disadvantage compared to the incumbent cable operators, who would not be subject to the disincentives created by such mandatory cost allocation methods. . . .[13]

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[11] "If the rules are not neutral with respect to the various alternative technologies available for providing a broad class of services, our cost allocation rules may inadvertently create an uneconomic incentive for carriers to use a technology other than the most efficient technology." *NPRM* at para. 25.

[12] USTA at 10. Of course, there may remain valid technological and equipment cost reasons why some carriers may choose to build separate systems regardless of cost allocation rules.

[13] Southwestern Bell at 13.

The Commission is unlikely to handcuff with prescribed cost allocation current video services' providers that begin to offer integrated telecommunications services with their video delivery technology. These providers will be allowed to allocate costs at will and price accordingly. If allocation is rigidly prescribed for incumbent LECs, the technology convergences of telephone to video and video to telephone are likely to be determined primarily by the Commission's intervention, thereby promoting a less than optimally efficient result.[14]

II. THE OUTCOME IN THIS PROCEEDING SHOULD ENCOURAGE ELIGIBLE TELECOMMUNICATIONS CARRIERS IN THEIR CONTRIBUTIONS TO UNIVERSAL SERVICE GOALS.

Besides the "level playing field" considerations in competitive markets contested by traditional regulated telephone companies and cable TV providers as discussed above, the Commission must also recognize the cost recovery needs of those carriers designated as "Eligible Telecommunications Carriers" and their universal service contribution to evolving technology and advanced service offerings. An adequate allocation of common costs to those regulated costs subject to universal service support would be consistent with the results-oriented form of competition that Congress has envisioned. If an adequate allocation to those costs qualifying for

[14] Some commenting parties either note the disparate treatment between LECs and cable operators or suggest that if a rigid prescribed allocation is adopted, cable operators should be subject to the same rules. BellSouth at 2 ("It ignores the anticompetitive effects of forcing one, and only one, player . . . to compete wearing regulatory handcuffs."); Bell Atlantic at 8, n. 22 ("The solution here should also be applicable when rate-regulated cable television companies use their cable facilities to provide competitive telephone service."); USTA at 10 (". . . these additional regulatory obstacles applied only to the incumbent LECs will thwart the stated goal of the Telecom Act of 1996. . . ."); and SNET, Summary at v. ("If the Commission believes that regulation of a LEC's cost allocations between telephony and video is warranted on the theory that LECs have market power in telephony, the agency must impose these same requirements on incumbent cable TV operators as well since it has held that those companies have market power in the multi-channel video market.")

universal service support leads to 1) the deployment of advanced video programming services in rural areas, 2) further savings from additional economies of scale and scope, and 3) evolving modern services, then the balanced goals are met.

Bell Atlantic, arguing in favor of more cost to regulated services than apparently proposed in the *NPRM*, adds:

> . . . this allocation history is consistent with designing a network to provide both regulated and non-regulated services. First, incumbent LECs retain a universal service obligation that requires them to engineer the network to offer service to 100% of the homes and businesses in a serving area, regardless of competition. For video and other non-regulated services, the networks need only be engineered to accommodate expected market penetration -- a far lower number.[15]

An overallocation to video would over-price video services to those in need of universal service support for advanced services comparable to those available in urban areas and would under-allocate to traditional telephone cost recovery sources including the new universal service mechanisms. In any event, rural and high-cost users should not be ironically "shot in the foot," denied initiation or improvements in video programming from their incumbent LEC because cost allocation is overprescribed under the misguided need to protect rural customers from cross-subsidization that does not exist. "The accurate allocation of costs will support the just and reasonable rates paid by all subscribers, and also provide the means to maintain and upgrade the carriers' facilities (to the benefit of regulated and nonregulated services' customers) as demanded by the regulated marketplace."[16]

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[15] Bell Atlantic at 10, footnote omitted.

[16] USTA at 15.

III. A FIXED ALLOCATOR OR ALLOCATION CAPS WOULD BE WRONG.

Nearly all of the LEC commenting parties reject the fixed allocator or capped allocation proposals contained in the *NPRM*.[17] The 50% allocation factor should be rejected because it would allocate an excessive amount to video programming services' activities. Bell Atlantic provides first-hand experience data that suggests a much lower reasonable allocation.[18] In Bell Atlantic's application, the allocation percentage is consistent with the ratio of cable television lines to local telephone lines plus cable lines.[19] Southwestern Bell rejects the fixed factor on the basis that it would be arbitrary given different technologies, would drive the price of video services, would fail to recognize integrated systems with varying degrees of video services deployment, and would be an inappropriate solution to what is "inherently an arbitrary process."[20]

US West opposes the Commission's form of fixed factor allocation. US West observes that "normal network upgrades and replacement of facilities might be chilled" because facilities capable of carrying video signals would be immediately allocated 50 percent to nonregulated video services' activities.[21] A 50 percent fixed factor approach would cause a drastic overallocation to video services during the start-up phase while at the same time causing an "artificial lowering of costs on the regulated side."[22] Instead, US West advocates allowing LECs

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[17] *NPRM* at paras. 37-42 proposing a fixed factor; and paras. 35-36 proposing a cost allocation ceiling. The ceiling as proposed would be an absolute value capped cost with potentially prescribed decreases in costs allocated to regulated activities.

[18] Bell Atlantic at 9-11.

[19] *Id.* at 10.

[20] Southwestern Bell at 13-15.

[21] US West at 9.

[22] *Id.* at 9-10.

to use a 50/50 allocator, but only with respect "to the loops actually used for both video and telephony."[23] US West notes several advantages in that its approach "more accurately reflects actual usage," "permits a more gradual reallocation of costs from the regulated to the nonregulated side," and "encourages more productive use of existing telephone plant."[24]

BellSouth also notes that it uses "forecasted count of circuits provided to subscribers to cable service and to telephone service."[25] BellSouth rejects the Commission's fixed factor approach for nearly identical reasons as those of US West. Southwestern also argues that the rules should flexibly allow a usage allocator based on a relative number of service connections.[26] "The service connection (or virtual loop) allocator is simple, adaptable to evolving technologies, and consistent with economic principles."[27]

Some of the same commenting parties also reject a capped or ceiling allocation to regulated services. Absolute ceilings on cost, as opposed to fractions of cost, would impose an inappropriate "prudency" test.[28] Bell Atlantic correctly observes that a ceiling would not be simple because it would need to recognize "increases in the regulated rate base caused by factors unrelated to the provision to non-regulated services" including inflation, new lines, new services,

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[23] *Id.* at 10-11.

[24] *Id.* at 12.

[25] BellSouth at 19, footnote omitted. BellSouth "does not contend that its approach is an economically efficient method, but only that it is preferable to other arbitrary methods." *Id.* at n.34.

[26] Southwestern Bell at 15.

[27] Southwestern Bell at 6.

[28] Southwestern Bell at 12.

and new loop costs.[29] Bell Atlantic suggests that a ceiling approach should be limited to an option at the discretion of the carrier.[30]

For these reasons, the RTC agrees that the fixed factor and ceiling allocation approach should not be adopted as mandatory requirements.[31]

IV. THE DELICATE BALANCE AMONG THE CONFLICTING ISSUES ARGUES IN FAVOR OF MAINTAINING THE EXISTING RULES WITH A GREATER DEGREE OF FLEXIBILITY.

Southwestern Bell and others argue that the *Joint Cost Order*[32] adopted in the regulated/non-regulated cost allocation proceeding is sufficient for the allocation of costs between regulated and video programming services.[33] The RTC agrees with most of Southwestern's conclusions:

> To the extent Part 64 is retained . . . , the Commission should not replace the cost-causative foundations of the Joint Cost Order with fixed factors, cost ceilings or other rigidly uniform cost allocation methods. If the Commission makes any

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[29] Bell Atlantic at 11.

[30] *Id.*

[31] It is sufficient to conclude that regulated services are not subsidizing nonregulated services if nonregulated services receive at least an incremental cost allocation and regulated services bear no more than their stand-alone costs. Non-regulated services are not subsidizing regulated services if regulated services receive at least an incremental cost allocation and non-regulated services bear no more than their stand-alone costs. The corollary is that neither regulated nor nonregulated services are subsidizing their counterparts if the allocation of costs to each is at least at the level of its individual incremental cost and no more than its individual stand-alone costs. *See* SNET, Affidavit of Dr. William Taylor at paras. 5-9. "We seek to establish bounds on cost assignment that would prevent misallocations (or over-allocation) of costs that are common to the regulated and nonregulated activities. . . . Economists have addressed these issues by defining the terms incremental and stand-alone costs." *NPRM* at para. 20.

[32] CC Docket No. 86-111, 2 FCC Rcd 1298 (1987), *recon.*, 2 FCC Rcd 6283 (1987), *further recon.*, 3 FCC Rcd 6701 (1988).

[33] Southwestern Bell at 5-7. *See also*, *e.g.*, USTA at 15-18; BellSouth at 17-22; US West at 5-8; and Bell Atlantic at 11-13.

changes to Part 64, the changes should allow more, not less, flexibility in applying the cost-causative hierarchy of cost allocation principles of the Joint Cost Order. To avoid frustrating the pro-competitive, deregulatory intent of the 1996 Act and deterring LEC entry into new markets, the Commission must continue to allow Part 64 principles to be adaptable to the variety of operations, systems, markets,, regional differences in costs and other unique circumstances of the individual LECs.[34]

The RTC also agrees with USTA that many LECs have been operating under the current Part 64 rules for several years, including those that have been providing video programming under the former rural exemption to the cross-ownership rules, without "any allegations that those rules have not worked effectively to protect ratepayers and competition."[35] Notwithstanding some critics conclusory claims that Part 64 is inadequate, economist Dr. William Taylor says that Part 64 and fully distributed cost allocation, in general, protect telephone customers by assigning too much to nonregulated services.[36]

If anything, the RTC submits that Part 64 requires more flexibility, rather than less.[37] US West and Bell Atlantic, for example, support elimination of the three-year peak usage forecast requirement.[38] Sufficient time has passed, certainly now with the enactment of the Act, that it is no longer necessary for the rules to impose a forecasting penalty that mandates an over-allocation to nonregulated services.[39] In this regard, requiring a more complicated allocation of spare

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[34] Southwestern Bell at 25.

[35] USTA at 15.

[36] SNET, Appendix at 7.

[37] BellSouth argues that if the Commission retains allocation rules, they should be made less, not more, arbitrary. BellSouth at 17-22.

[38] 47 C.F.R. § 64.901(b)(4). *See* US West at 12-13; Bell Atlantic at 12.

[39] LECs "should not be faced with unrecoverable sunk costs and stranded investment created by cost allocations rules" based on previously overestimated market penetration and

capacity apart from the current allocation based on the "in-use" plant is unnecessary and would be overkill. The in-service forecast peak use already allocates a sufficient amount to unregulated activities. Commenting parties agree that the concerns expressed by the Commission about spare facilities and possible changes are unwarranted.[40] US West summarizes a productive point to remember:

> The Commission should not fail to recognize that the need to continue to provide high-quality, up-to-date service at an affordable price requires LECs to upgrade and replace facilities. The fact that the upgraded facilities may be capable of providing additional nonregulated services in the future should be viewed an advantage to the regulated ratepayer because the nonregulated service customers would pay for a share of the common costs that were previously borne solely by the regulated ratepayers.[41]

Specifically with respect to fiber optic plant, BellSouth is correct:

> [T]he incremental installation cost of additional capacity is negligible. Thus, deployment of fiber for future utilization is a prudent engineering and business decision for the telephone business and is directly beneficial to telephone customers. No additional methodologies are needed to allocate spare capacity.[42]

Finally, the commenting parties generally agree that there is no need to modify any rules to accommodate what are perhaps misunderstood requirements of the Act with respect to imputation of pole attachment and conduit rental.[43] The apparent misapplication of the Act is rooted in

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success in video program service markets. US West at 13. "[T]his allocation method would more closely reflect cost-causation if reallocation of investment from nonregulated to regulated were allowed more easily when external factors reduce the nonregulated usage of investment." Southwestern Bell at n.23.

[40] USTA at 18-20; Bell Atlantic at 13-14; Southwestern Bell at 19-21; BellSouth at 22.

[41] US West at 14. "As a result, any allocation of common costs allows customers of regulated service to benefit from the economies of scope of a multi-use network." Bell Atlantic at 9.

[42] BellSouth at 22.

[43] BellSouth at 23; Southwestern Bell at 22; Bell Atlantic at 12; and USTA at 21.

confusion between imputation and cost allocation. In any event, the RTC agrees that there is no need to make any changes for pole attachments and conduit rental.

V. CONCLUSION

For the reasons summarized above, the RTC recommends that the Commission limit any changes in its Part 64 rules to granting greater flexibility and options. There is no need to adopt rigidly prescribed rules for the allocation of common costs between regulated telecommunications services and video programming services' activities. Instead, the Commission should promote vigorous investment in integrated video delivery systems without requiring new, nonregulated activities to bear an unreasonable share of costs. The goals established by Congress will best be served by a flexible approach.

Respectfully submitted,

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June 12, 1996

CERTIFICATE OF SERVICE

I, Gail C. Malloy, certify that a copy of the foregoing Reply Comments of the National Telephone Cooperative Association in CC Docket No. 96-112 was served on this 12th day of June 1996, by first-class, U.S. Mail, postage prepaid, to the following persons on the attached service list:

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